United States Court of Appeals

for the Second Circuit

APPELLANT'S BRIEF

74-2306

United States Court of Appeals

FOR THE SECOND CIRCUIT

Docket No. 74-2306

IN THE MATTER

of

FAS INTERNATIONAL, INC.,

Debtor.

UNITED STATES TRUST COMPANY OF NEW YORK,

Successor Indenture Trustee-Appellant,

FAS INTERNATIONAL, INC.,

Debtor-Appellee.

ON APPEAL FROM THE UNITED STATES DISTRICT COURT
FOR THE SOUTHERN DISTRICT OF NEW YORK

BRIEF OF APPELLANT

WHITMAN & RANSOM

Attorneys for Appellant

UNITED STATES TRUST COMPANY
OF NEW YORK
522 Fifth Avenue
New York, New York 10036
575-5800

JAMES C. SARGENT
ROBERT S. NEWMAN
WILLIAM M. KAHN
DUGALD C. BROWN

Of Counsel

New York, New York
December 30, 1974

TABLE OF CONTENTS

Cases

Other Authorities

United States Court of Appeals

FOR THE SECOND CIRCUIT

Docket No. 74-2306

IN THE MATTER

of

FAS INTERNATIONAL, INC.,
Debtor.

UNITED STATES TRUST COMPANY OF NEW YORK,
Successor Indenture Trustee-Appellant,

FAS INTERNATIONAL, INC.,
Debtor-Appellee.

ON APPEAL FROM THE UNITED STATES DISTRICT COURT
FOR THE SOUTHERN DISTRICT OF NEW YORK

BRIEF OF APPELLANT

Preliminary Statement

FAS INTERNATIONAL, INC., the Debtor (sometimes herein referred to as FAS), filed a petition for arrangement under Chapter XI of the Bankruptcy Act, 11 U.S.C.A. § 701 et seq., on February 8, 1972 and thereafter proposed a plan of arrangement (the "Plan"). One of the classes of creditors included in the Plan was the class represented by the public holders of $16,500,000 of 5% Convertible Subordinated Debentures due 1989 issued by FAS pursuant to a written Trust Indenture. The holders of these debentures ("Debentureholders") were represented immediately prior

to and during the Chapter XI proceedings by The United States Trust Company of New York ("Appellant"), which had become Successor Indenture Trustee upon the resignation of the original Indenture Trustee, Manufacturers Hanover Bank. The Plan was confirmed and the Appellant and its counsel, Whitman & Ransom, Esqs., applied to the court for allowances for services performed by them during the pendency of the Chapter XI proceeding. By a memorandum opinion and order dated September 25, 1973, the Bankruptcy Court (Honorable Roy Babitt, Bankruptcy Judge (then the "Bankruptcy Referee")) denied such allowances. Appellant and its counsel appealed from the order of September 25, 1973 denying such allowances to the United States District Court, Southern District of New York. The District Court (Murray I. Gurfein, U.S.D.J.) affirmed in an opinion dated August 25, 1974. 382 F. Supp. 77 (S.D.N.Y. 1974). This appeal followed.

The Issue Presented for Review

Does the Bankruptcy Court in a Confirmed Chapter XI Arrangement Proceeding have the power to award allowances to an indenture trustee and its counsel in such proceeding who have rendered valuable services for subordinated public holders of debentures who, as a separate class of creditors, have interests adverse to the interests of the other unsecured creditors and were otherwise unrepresented?

Statement of the Case

Detailed descriptions of the services rendered by the Appellant and its counsel in connection with the Chapter XI proceeding are set forth in the application for allowances filed by Appellant and its counsel in the court below. These applications are included in the Appendix commencing at pages 5a and 11a, respectively, and are summarized in the following statement of the relevant facts.

Prior to the filing of its petition for an arrangement under Chapter XI, the Debtor had made efforts out of court to compose its debts with its various creditors. The creditor body, as categorized by the court below (53a-54a), consisted of a consortium of bank creditors, the trade creditors, and the Debentureholders. The debentures had initially been sold by the Debtor to the public in 1969; at the time the petition for arrangement was filed on February 8, 1972, the debentures were in the hands of more than 500 individual Debentureholders.

The efforts by FAS to compose its debts proved unsuccessful. Shortly before the filing of the petition and shortly thereafter FAS held meetings with representatives of the bank consortium and its trade creditors but not the Debentureholders. The Appellant, as Successor Indenture Trustee, and its counsel were not invited to attend such meetings because FAS and the other creditors regarded the $16,500,000 of publicly held debt as "subordinated" debt having no voice in the negotiation of a settlement between the Debtor and its other creditors (13a).

Article Thirteen of the Trust Indenture does provide that the debentures are subordinated to payment of "senior indebtedness" (consisting virtually entirely of bank debt), and further provides for the assignment of such subordinated debt to the senior indebtedness in the event of the Debtor's insolvency (24a, 25a). However, as more particularly explained below, the language employed by the draftsmen in defining the scope and extent of the subordination was ambiguous, and the resistance by Appellant's counsel to the attempt to subordinate the $16,500,000 of debt owed to the Debentureholders proved to be a substantial factor in achieving the plan of arrangement ultimately approved.

When Appellant first heard that FAS had filed a Chapter XI petition and that an unofficial committee of creditors had already been formed from which the Debentureholders were excluded, Appellant searched for a means to en-

able the Debentureholders to gain recognition of their rights against the Debtor, and to be considered in the negotiation of the Plan. Since this proceeding was in Chapter XI of the Bankruptcy Act, the Securities and Exchange Commission (SEC) could not intervene to protect the interests of public investors (unlike a Chapter X proceeding where the SEC may intervene, 11 U.S.C. § 608). The SEC could have moved under § 328 of the Bankruptcy Act for an order to dismiss the Chapter XI petition unless it was amended to comply with the provisions of Chapter X. Indeed, the SEC, after the Plan had been filed, did consider such action but decided against it (19a). Presumably the SEC was influenced in not making that motion by the appearance before its Staff of counsel for the Indenture Trustee who advised the SEC Staff of the protective steps taken for and on behalf of the public holders of the debentures by the Indenture Trustee. Appellant was therefore left alone to protect the rights of the public holders of the debentures (19a).

Based on rights granted to the indenture trustee under the express terms of the Indenture, Appellant solicited proofs of claim from the Debentureholders with powers of attorney running to Appellant and its counsel in order to vote such claims in favor of a creditors' committee consisting of representatives of all classes of creditors, including the Debentureholders, and for the election of Malcolm J. Hood, Senior Corporate Trust Officer of Appellant, as tentative trustee, at the first meeting of creditors to be held before the Bankruptcy Court (13a, 14a).

On March 14, 1972, the first meeting of creditors was held, and Appellant and its counsel appeared and voted the Debentureholders' proofs of claim in favor of the election of such a representative committee and for Mr. Hood as tentative trustee. A contest developed as to the composition of the committee, lasting the entire day, during which time the Appellant argued *inter alia* that the wording of the subordination provision in the Trust Indenture was somewhat ambiguous, raising a question as to whether the De-

bentureholders were subordinated in a situation where, as here, it was contemplated that the distribution in the reorganization be in shares of stock of the Debtor (24a). After submission of briefs, the Bankruptcy Court ruled that the Debentureholders in the aggregate could vote only one claim, and the court therefore declared the committee *containing no representatives of the Debentureholders* elected as the Official Creditors' Committee, thereby completely disenfranchising the $16,500,000 of publicly held debt from any voice whatsoever in the Chapter XI proceeding. Appellant through its counsel then filed a notice of appeal to the United States District Court, Southern District of New York, seeking a review of this decision.

Prior to the expiration of the time to perfect the appeal from the decision of the referee, negotiations commenced between FAS, the Official Creditors' Committee (representing the bank consortium and the trade creditors) and the Appellant, as representative of the Debentureholders, with respect to the formulation of a plan of arrangement which would be acceptable to all of the creditors including the Debentureholders (15a). The financial condition of FAS mandated that the Plan provide for payment to the unsecured creditors (with minor exceptions not relevant here) of only shares of common stock of FAS, such shares in the aggregate to total 80% of the issued and outstanding common stock of the Debtor. The principal question, therefore, was what proportion of the shares would be given to the various classes of creditors. In the course of such negotiations counsel for all sides conceded that Appellant had raised valid questions with respect to the scope and extent of the subordination and that therefore it would be impractical to attempt to confirm a plan which excluded the Debentureholders because of the virtual certainty of an appeal from the order confirming any such plan.

Ultimately an agreement was negotiated which was satisfactory to the Debtor, the Official Creditors' Committee and the Appellant acting on behalf of the public holders of

the debentures. The provisions of the agreement (which was oral) were that the Appellant would withdraw its petition for review of the aforesaid order of the Bankruptcy Court, and the Plan would provide that the Debentureholders receive in the aggregate 196,092 shares of the common stock of FAS. This number of shares would amount to approximately 20% of all of the issued and outstanding shares of FAS upon the completion of confirmation of the Plan. As noted above, with minor exceptions not relevant to this appeal, all unsecured creditors received shares of FAS stock under the Plan. No cash was involved (15a).

A further concession for the benefit of the Debentureholders was that an officer of the Appellant was to be elected as one of the five directors of the reorganized FAS to act for and on behalf of the Debentureholders. FAS complied with this provision.

The last consideration was that no objection would be made to any application by Appellant and its counsel for allowances for work performed by them in connection with the Chapter XI proceeding, and that the Debtor would pay such allowances if approved by the Bankruptcy Court.* This last provision was particularly important to Appellant because there was no cash being given to the Debentureholders under the Plan out of which to pay the expenses being incurred by Appellant to protect the rights of the public Debentureholders. Though FAS was, of course, expressly obligated to pay such expenses under the Indenture (23a), the intervention of the Chapter XI proceeding cast doubt as to whether such obligation survived.

The Appellant's applications for allowances describe the extensive amount of work performed by Appellant and its counsel before and after agreement on the Plan, including

---

* Counsel for the Debtor and the Official Creditors' Committee later disclaimed any agreement made "with respect to the payment of fees", contending any such agreement is "proscribed by statute" (32a, 33a).

the work which Appellant and its counsel were required to perform in order to comply with the formal requirements incident to confirmation of the Plan. Such work included, but was not limited to, the solicitation by Appellant of consents to the Plan, which solicitation was not performed by the Official Creditors' Committee (18a).

The Official Creditors' Committee declined to perform any of these important functions pertaining to the Debentureholders for the reason that the Debentureholders constituted a wholly separate class of creditors and were treated as such under the Plan. This was necessarily so since the Plan contemplated giving all creditors shares of the reorganized Debtor aggregating approximately 80% of the issued and outstanding shares, so that any shares given to the Debentureholders of necessity came from shares which would otherwise have been issued to other creditors. The Debentureholders therefore stood in a completely adverse position to the other creditors, both the senior indebtedness to whom the Debentureholders were allegedly subordinated, and the trade creditors to whom the Debentureholders were not subordinated.

Shortly after confirmation, in compliance with an order of the Bankruptcy Court, Appellant and its counsel filed applications for allowances.

In accordance with the agreement made by counsel for the Official Creditors' Committee and counsel for the Debtor, no objections were raised by any party to the applications for allowances made by Appellant and its counsel. Nevertheless, the Bankruptcy Court, though it commended the Appellant for the "sterling services" rendered on behalf of the Debentureholders, denied both applications on the ground that it had no power to award an allowance for such services in a Chapter XI proceeding. The Court made the following comments regarding the services performed:

> "I also think I need do no more than comment on the indenture turstee's [*sic*] sterling services rendered for

> the beneficiaries of the trust—the subordinate debentureholders. I am willing to accept as a finding of ultimate fact that it was by reason of the services by the attorneys for the indenture trustee and by that trustee himself which resulted in inclusion of that class of creditors in the debtor's arrangement proposals. Certainly the debtor need not have accommodated subordinate debt inasmuch as the primary debt was not being accommodated in full. See *In re Itemlab, Inc.*, 197 F. Supp. 194 (E.D.N.Y. 1961). Similarly, it may be assumed that the indenture trustee performed fine services for the class in keeping with the duties imposed on indenture trustees." (47a)

The Court then held, however, that the Bankruptcy Court lacked the power to award compensation to the Indenture Trustee because of the absence of express authority in the Bankruptcy Act (48a). Appellant then prosecuted its appeal to the District Court.

Subsequent to the filing of said notice of appeal to the District Court, the Bankruptcy Court, by letter dated October 22, 1973, directed counsel for the Debtor to defend the appeal (30a). Thereafter, Levin and Weintraub, Esqs., co-counsel to the Official Creditors' Committee, announced that they would follow such direction and take a position adverse to Appellant on the appeal to the District Court (31a).

A cogent commentary on the opinion of the bankruptcy court and the conduct of that court in directing the Debtor to oppose said appeal, is contained in the letter dated November 6, 1973 from Edward Fein, Esq., Senior Vice President and General Counsel of the Debtor, directed to the attorneys for the Debtor, appearing in the Appendix, 34a, 35a, 36a. In this letter, Mr. Fein refers to his conversation with "Don", who is Donald S. Lewis, the President of the Debtor, and states that he and Mr. Lewis "believe that the cited actions of the Indenture Trustee and its counsel were indispensable to the successful achievement

of Confirmation of the Arrangement" (35a). Mr. Fein also points out that the Official Creditors' Committee not only refused to solicit acceptances of the arrangement from Debentureholders but also refused to permit the Debtor to include in its proxy solicitation material a copy of the letter used to solicit acceptances from Debentureholders. Mr. Fein goes on to point out that the letter to the Debentureholders urging acceptance of the Plan was prepared and sent out by the Appellant on advice of its counsel and Mr. Fein terms the failure of Appellant and its counsel to be compensated by the Debtor for such services to be "unfortunate." "The only voice in support of the subordinated debt was that of the Indenture Trustee by its counsel" (34a).

The Decision below

The opinion of the court below (Gurfein, J.), in affirming the decision of the Bankruptcy Court, held that, since the allowances sought by Appellant and its counsel were not expressly provided for by the Bankruptcy Act, the Bankruptcy Court lacked the power to grant the same. The court further held that under such circumstances, and because Congress had not seen fit to amend Chapter XI expressly to allow for such compensation to indenture trustees, the equity powers of the court could not be invoked (52a-63a).

It is respectfully submitted that the Bankruptcy Act and judicial precedent permit the award of such allowances in the particular circumstances involved in the present proceeding and that the equity powers of the Bankruptcy Court are not so narrow or limited.

POINT I

The Court Below Erred in Holding That the Bankruptcy Court Has No Authority to Compensate an Indenture Trustee and its Counsel in a Chapter XI Proceeding.

The holding of the court below was based on a decision of this court rendered in 1941, three years subsequent to the passage by Congress of the Chandler Act, which added

inter alia, Chapter XI to the Bankruptcy Act. That decision, *Lane* v. *Haytian Corp.,* 117 F. 2d 216 *cert. denied,* 313 U.S. 580 (1941) (the "*Lane* case"), does not warrant denial of allowances to the Indenture Trustee and its counsel in the circumstances of this case.

First of all, the *Lane* case did not even involve an application for an allowance by an indenture trustee, and consequently was not a holding by this court on the precise issue raised by the present case. That case involved an application in a Chapter XI proceeding by an "Independent Protective Committee for debtor's bondholders" ("IPC") and by the attorney for such committee. The bondholders were "by no means exclusively" represented either by the independent protective committee or that committee's counsel (117 F. 2d at 218). Some of the debentureholders appeared by their own counsel and participated in the proceeding. Moreover, the members of the IPC and their counsel relied in their application solely on the provisions of the plan of arrangement which specified that the bondholders' committee and its attorneys were to be compensated for the reasonable value of their services and that consequently the obligation to pay for such services constituted a "firm engagement" equivalent to an ordinary contract claim under Section 357(6) of the Bankruptcy Act (11 U.S.C. § 757(6). The Court held that a "promise to compensate an unofficial committee of creditors and its attorney or agents is not the kind of 'debt' contemplated by 357(6)***". (117 F. 2d at 218.)

That decision is patently distinguishable from the present application. Here the Appellant as indenture trustee has exclusively represented all of the Debentureholders in this proceeding, who would otherwise be without representation, and is not asserting its claim as a "debt" under Section 357(6); nor is the indenture trustee's application in this proceeding being contested except as subsequently directed by the Bankruptcy Court. Moreover, the *Lane* case, in so far as it restricted the compensation and function of creditors' committees in Chapter XI proceedings, was

specifically overruled by statute in 1952 by an amendment to Section 337, by a 1958 amendment to Section 337 and by the 1967 amendment to Section 337 and the addition of Section 339. (See Collier, *Bankruptcy Act* § 337 at A263 (Pamphlet ed. 1971) and H.R. Rep. No. 121 90th Cong., 1st Sess. (1967).

> "The decision in *Lane v. Haytian Corporation of America,* 117 F. (2d) (*sic*) 216 (2d Cir. 1941) limited compensation to a committee's attorneys and agents from the time it became official, i.e., the initial meeting of creditors (now the first meeting of creditors), and restricted such compensation to passing judgment on the plan and making that judgment known to the debtor and creditors. It also provided very narrow areas for the committee's activities.
>
> "In 1952, section 337(2) was amended with the purpose of overcoming the effects of the *Haytian case.****
>
> "The proposed amendments will carry out the purposes of dealing fairly and realistically with the creditors' committee which performs a most important function in arrangement proceedings, i.e., in passing judgment on a plan and making that judgment known to the creditors. Without the countervailing position of a creditors' committee, chapter XI would be a unilateral proceeding proposed by a debtor and approved by an uninformed creditor group. The only method of strengthening the powers of the committee is to insure that its attorneys, accountants and agents are compensated for their services." H.R. Rep. No. 121, 90th Cong., 1st Sess. (1967).

The recent amplification of the rights of a creditors' committee in Chapter XI proceedings may be seen by the changes in the statute. Section 337(2) (11 U.S.C. § 737(2) after its amendment in 1952 read as follows:

> "At such meeting, or at any adjournment thereof, the judge or referee shall, after the acceptance of the arrangement —

> . . . (2)Fix a time within which the debtor shall deposit,*** the consideration, if any, to be distributed to the creditors, the money necessary to pay all debts which have priority, *** and the money necessary to pay the costs and expenses of the proceedings, (and the actual and necessary expenses, including fees and expenses ((of attorneys, accountants and agents)),* in such amounts as the court may allow, incurred after its appointment by a committee appointed * * * before or after the filing of the petition under this chapter by a committee designated in writings, filed with the court and signed and acknowledged by a majority in amount of unsecured creditors whose claims have been scheduled otherwise than as contingent unliquidated or disputed and who would not be disqualified by section 44 of this Act to participate in the appointment of a trustee: *Provided, however,* That in fixing any such allowances the court shall give consideration only to the services which contributed to the arrangement confirmed or to the refusal of confirmation of an arrangement, or which were beneficial in the administration of the estate, and the proper costs and expenses incident thereto); and''
>
> * * *

A 1967 amendment, Pub. L. 90-158, 90th Cong. 1st Sess. (1967) deleted all of the language set forth above within the parentheses (commencing with line 5) so that section 337(2) now ends with the words ''of the proceedings; and''. (See line 5 of the quoted language). The 1967 amendment further added a new section 339 to the Bankruptcy Act (11 U.S.C. § 739).

Section 339 (1) spells out the functions which may be performed by the committee. Section 339 (2) provides that such a committee ''may employ such agents, attorneys and

---

* Parenthesis supplied. The language appearing in the double parentheses was added by Pub. L. 85-732, 85th Cong. 2d Sess. (1958).

accountants as may be necessary to assist in the performance of its functions''—a far cry from the narrow interpretation of the *Lane* case. Section 339(2) also provides that ''(e)xpenses of the committee for such assistance, whether incurred before or after the filing of the petition under this chapter, shall be allowed as an expense of administration to the extent deemed reasonable and necessary by the court, provided the arrangement is confirmed''. Clearly the intent of Congress was to enlarge substantially the scope of reimbursable expenses of the creditors' representatives to ''fairly and realistically'' enable them to perform their ''most important function''. H.R. Rep. No. 121, 90th Cong. 1st Sess. (1967) *supra* at 11.

Appellant concedes that the statutory amendments which overruled the *Lane* case do not expressly provide for the payment of compensation to an indenture trustee in Chapter XI proceedings. Since no authority existed for the denial of allowances to an indenture trustee under Chapter XI, there was no reason for Congress to add any further amendments in 1952 and 1967 to include such express authority. No such question had ever been raised before and therefore it may reasonably be assumed that Congress was not aware that any problem existed. Certainly there was no express language in the Act which prohibited an award of such allowances to an indenture trustee. Though Congress was aware of the *Lane* case, this Court in that case (and presumably Congress) never considered the question of compensating an indenture trustee who represented *all* debentureholders, not otherwise represented, since that issue was not before this court.

Indeed a diligent search for authority on the subject has failed to disclose any decision on this precise issue except a decision of Judge McLean of the District Court of the Southern District of New York in 1966 *In the Matter of Straus-Duparquet, Inc.* (the ''*Straus* Case'') 65 B 181, (S.D.N.Y. May 10, 1966) and a decision of Bankruptcy

Judge C. Albert Parente *In the Matter of Fotochrome, Inc.* (the "*Fotochrome* Case") 70 B 209 (E.D.N.Y. 1972). Copies of both opinions appear in the Appendix at pages 37a-45a.

In the *Straus* case the Chemical Bank New York Trust Company, indenture trustee ("Chemical") applied to the Bankruptcy Court (Referee Herbert Lowenthal) for an allowance for services rendered during the Chapter XI arrangement proceeding. Services set forth in its application for allowance (included in the appendix at 39a-42a) are described as analyses of various papers and financial data, conducting advisory services to the debentureholders, attendance at meetings of the creditors' committee and assorted other services customarily rendered by the counsel for the official creditors' committee. The debentureholders in that proceeding were not subordinated and consequently their interests were identical to those of all other general unsecured creditors and the work performed by the indenture trustee's counsel was merely duplicative of the work of counsel for the official creditors' committee. In denying Chemical an allowance, Judge McLean stated: "The law is settled that the Bankruptcy Court lacks power to grant compensation which is not expressly provided for in the Bankruptcy Act." Judge McLean then cited five cases. None of these cases involved an indenture trustee or the right of the court to award an allowance to an indenture trustee or his counsel.

In the *Fotochrome* case the identical issue was raised. In that case, however, the allowance of an award to the indenture trustee and its counsel was included in the plan of arrangement. Nevertheless, the debtor objected to the allowance on the ground that the court did not have the power to award such allowance. Bankruptcy Judge Parente (then the "Bankruptcy Referee") in granting the allowance, stated:

> "Allowances in proceedings under Chapter XI of the Bankruptcy Act to an indenture trustee are not statu-

torily prescribed. Conversely the statute contains no express interdiction relative thereto.

"In the exercise of said discretion and in accord with the generic equity concept, I conclude that payment of expenses to the indenture trustee in this proceeding is justified and in harmony with the intent of Section 357 of the Bankruptcy Act (11 U.S.C. 757), subsections (1), (6) & (8).***"

Neither of these cases involved the precise issue involved in the case at bar since the interests of the debentureholders in both cases were identical to the interests of the other general unsecured creditors, and consequently the services performed by the indenture trustee and its counsel were merely duplicative of the services of the official committee counsel. This was due to the fact that in both of the above cases the debentureholders were not subordinated and therefore had no apparent interest adverse to the remaining creditor body and were consequently not a separate class of creditors under the plan.

The services of the official creditors' committee and their counsel in those cases were therefore entirely adequate for the protection of both the publicly held debentures and the trade creditors. The court in *Fotochrome* nevertheless granted the allowance; *a fortiori* an allowance should be granted in the instant case.

In the present proceeding, the Debentureholders had interests adverse to the remaining creditor body, and indeed the negotiations which took place were not the conventional two party negotiations between the debtor and the creditors' committee but the unique (up to this date) negotiations between three parties, i.e., the debtor, the creditors (consisting of the senior indebtedness, other indebtedness and the trade creditors) and the subordinated Debentureholders (who were represented by the Appellant Indenture Trustee and its counsel). Since the question of the validity and scope of the subordination was undetermined, the subordi-

nated Debentureholders were required to negotiate with the Official Creditors' Committee as well as with the Debtor.

Concededly the 1967 amendments to Chapter XI enlarged both the functions of the creditors' committee and the rights of such a committee to employ attorneys, agents and accountants. But even with such enlarged powers such a creditors' committee certainly could not "fairly and realistically" [H.R. Rep. No. 121 90th Cong. 1st Sess. (1967) *supra* at 11] represent two separate classes of creditors in direct conflict with each other. Because of the existence of such a direct conflict between the classes of creditors in the present case, the Official Committee did not even purport to act for the Debentureholders, even though the subordinated Debentureholders were general unsecured creditors of the debtor. Clearly, because of the direct conflict existing between these two classes of creditors, the subordinated Debentureholders required representation by separate counsel.

It has never before been held in a Chapter XI proceeding that subordinated debentureholders, as general unsecured creditors, may be deprived of independent counsel where an issue arises as to whether and to what extent they are subordinated. Chapter XI treats all general unsecured creditors equally, yet without the right to such separate counsel their interests would, in reality, not be represented, certainly not "fairly and realistically" represented.

The court below also cited *Guerin* v. *Weil, Gotshal & Manges,* 205 F. 2d 302 (2d Cir. 1953) for the proposition that the Bankruptcy Court lacks power to grant compensation not expressly provided for by the Act. A reading of that case, however, indicates it did not involve a Chapter XI proceeding or indenture trustee at all. It involved the question as to whether the attorneys for the petitioning creditors in a straight bankruptcy proceeding were entitled to be reimbursed for disbursements, consisting of expenses

paid to appraisers and accountants employed by such attorneys on the trial of the issue of insolvency. Clearly that case has no applicability to the case at bar. Moreover, the aforementioned amendments to Section 337(2) of the Bankruptcy Act and the 1967 amendment adding a new Section 339 (which provides that an official creditors committee "may employ such agent, attorneys, and accountants as may be necessary to assist in the performance of its function*** whether incurred before or after the filing of this petition***") render the *Guerin* case obsolete, just as *Lane* is obsolete.

Additionally, in the *Lane* decision, Judge Clark pointed out that when the Chandler Act was passed in 1938 it was not then foreseen that Chapter XI arrangement proceedings would ever be used for the reorganization of a large business enterprise with various tiers of debt, the shares and debt of which were publicly held. A Chapter XI proceeding was intended to be more in the nature of a simple composition with creditors.

In the intervening years recourse to Chapter XI by large enterprises has increased. The reasons for this increased resort to the use of a Chapter XI proceeding by large companies are many, but the absence of the absolute priority rules applicable to Chapter X is a major one, and it may be expected that the increased use of Chapter XI by large companies with publicly held shares and tiers of debt will continue.

The use of subordinated convertible debt to raise capital is a common device so that the question presented here may be expected to recur. A determination excluding the indenture trustee and its counsel from compensation will impose a heavy burden on such public subordinated debtholders in finding adequate representation particularly where, as here, the plan provides for the payment in shares only. Moreover, a heavy and involuntary burden will be placed on all of the banking institutions who act as indenture trustees

for publicly held debt securities. Since the SEC is not a party to Chapter XI proceedings, an indenture trustee will often be the only party seeking to protect the public debtholders. Yet the decision below mandates that all expenses incurred by such trustees in protecting and in defending the public interest in such Chapter XI cases, and all expenses incurred in complying with their duties under the Indenture and under the Trust Indenture Act of 1939, 15 U.S.C. § 77aaa et seq., and related laws, must be borne entirely by such trustees even though the Trust Indenture provides that such costs shall be paid by the Debtor. Since no such risk is contemplated by the banking institutions when they become trustees under Indentures, the decision below, if sustained (a) will make it difficult to find institutions willing to act as indenture trustees, (b) result in a substantial increase in the charges for such work to cover all potential unreimbursed services under Chapter XI proceedings, or (c) require that in such cases recourse to Chapter XI be denied to such companies having public debt.

Admittedly Chapter XI was not originally intended for this type of case, but the success of this proceeding and other similar cases which have been successfully concluded recently under Chapter XI has proven the flexibility of the statute. The fact that such arrangements have been successful, we submit, is in a large measure due to the wisdom of the courts in reading the statute broadly and flexibly to permit Chapter XI debtors to work out their problems within the framework of the statute. In order to reach a fair and realistic result the parties here (including the committee) have solved the technical problem by agreeing to treat the indenture trustee and its counsel as though they were "official" and by permitting them to apply for compensation without objection. We submit that this solution is within the flexibility already found by the courts to be an integral part of the statute.

POINT II

The Equitable Concepts Embodied in the Bankruptcy Act Permit the Award of Allowances to the Appellant

Bankruptcy courts, which were constituted by Section 2 of the Bankruptcy Act, are vested with broad powers based on equitable concepts (11 U.S.C. § 11). The Supreme Court of the United States has consistently emphasized that a bankruptcy court is a court of equity, guided by equitable principles and doctrines, where "substance will not give way to form [and] technical considerations will not prevent substantial justice from being done." *Pepper* v. *Litton*, 308 U.S. 295, 305 (1939). The broad equity powers of the Bankruptcy Court are sharply illustrated in the case of *Bank of Marin* v. *England*, 385 U.S. 99 (1966). In that case, prior to its bankruptcy, the bankrupt had drawn checks on the Bank of Marin which had honored such checks subsequent to the bankruptcy. The Trustee brought suit against the payee and the Bank of Marin and the Bankruptcy Court determined that the payee and the Bank of Marin were jointly liable to the Trustee. This determination was made on the express provisions of Section 70(d)(5) of the Bankruptcy Act that no transfer by the bankrupt "after the date of bankruptcy shall be valid against the Trustee". Justice Douglas in reversing the Bankruptcy Court, said (385 U.S. 99 at 103):

> "Yet we do not read these statutory words with the ease of a computer. There is an overriding consideration that equitable principles govern the exercise of bankruptcy jurisdiction. Section 2a, 52 Stat 842, 11 USC 11(a); *Pepper* v. *Litton*, 308 US 295, 304-305, 94 L.Ed 281, 287, 288, 60 S Ct 238; *Securities & Exchange Commission* v. *U.S. Realty & Imp. Co.* 310 US 434, 455, 94 L.Ed. 1293, 1303, 60 Sup. Ct. 1044. We have said enough to indicate why it would be inequitable to hold liable a drawee who pays checks of the bankrupt duly drawn but presented after bankruptcy, where no

> actual revocation of its authority has been made and it has no notice or knowledge of the bankruptcy."

This decision virtually overruled Section 70(d)(5) as applied to the facts there before the court. The rigid application of the express provisions of the Bankruptcy Act would have resulted in a severe inequity to the Bank of Marin and, acceding to the "overriding consideration that equitable principles govern the exercise of Bankruptcy jurisdiction", the Supreme Court simply refused to enforce the express terms of the Bankruptcy Act in order to reach an equitable result. We believe that the granting of the present allowances are less violative of the provisions of the Bankruptcy Act than the decision of the United States Supreme Court in the *Bank of Marin* case, and that by every known standard of equity, these allowances should be granted.

The express terms of the Trust Indenture under which Appellant acted specifically require that all expenses, including legal fees, incurred by Appellant in connection with its duties as indenture trustee be paid by the Debtor. Appellant was a successor indenture trustee, not the original trustee, inheriting the burdens but few benefits of a position as guardian of the interests of public investors. Because of the express provisions of the Indenture it relied on the fact that the acceptance of such a burden would at least be recompensed. Surely no banking institution would voluntarily undertake such a burden at its own expense. If the indenture trustee neglected or declined to perform some required functions, there can be no question of its liability to its *cestuis que trusts*, the public debentureholders. See *Dabney* v. *Chase National Bank of the City of New York*, 201 F. 2d 635 (2d Cir. 1953). Yet the court below, though conceding that Appellant rendered "sterling services" on behalf of the Debentureholders "in keeping with the duties imposed on indenture trustees" (47a) ruled that Appellant and its counsel may not be compensated for such services because Chapter XI of the Bankruptcy Act

does not specifically provide for payments to a successor indenture trustee and its counsel. The refusal to grant allowances to the Appellant on this basis conflicts with the principle stated in 1 Remington, *Bankruptcy* § 22 (5 ed. 1950) that "where the Act [Bankruptcy] is silent . . . equitable principles rather than those of law control." *In Re Romanac,* 245 F. Supp. 882, 886 (W.D. Va. 1965) *aff'd. National Bank & Trust Co.* v. *Allied Supply Co.,* 386 F. 2d 225 (4th Cir. 1967). The silence of the Bankruptcy Act should therefore not be a bar to granting the allowances. The broad equity powers of the Bankruptcy Court can always be invoked to prevent injustice.

In the words of the Supreme Court in the case of *Securities and Exchange Commission* v. *United States Realty and Improvement Company, supra,* in discussing the lack of clarity in the Bankruptcy Act as to whether "a corporation is small or large, its security holders few or many":

> "The answer turns not on the courts' statutory jurisdiction to entertain a proceeding under Chapter XI, but on considerations growing out of the public policy of the Act found both in its legislative history and in an analysis of its terms, and of the authority of the court clothed with equity powers and sitting in bankruptcy to give effect to that policy . . ." 310 U.S. 434, 448, 84 L. Ed. 1293, 1299 (1939)

Certainly the public policy in the case at bar should not be shunted aside as it has been in the lower courts. The Debentureholders were given protection in this case solely because of the actions of the indenture trustee and its counsel, and public policy requires that such protection be accorded where the issuing company has filed in Chapter XI and where, as here, the official committee does not provide such protection. "A court of equity may in its discretion in the exercise of the jurisdiction committed to it grant or deny relief upon performance of a condition which will safeguard the public interest." *Id.* at 455.

According to the court below, it is without power to grant such compensation in the face of an alleged Congressional intent that only the one "Official" Committee "charged with representing 'the creditors' without exception" is entitled to such compensation. (62a) The court below assumed, however, that if it could be shown that Congress had overlooked the situation such as is now before the Court, the equitable powers of the Bankruptcy Court could be invoked to provide relief (60a), citing *Bank of Marin* v. *England, supra.*

We have seen that the *Bank of Marin* case affords support for Appellant's view that the equity powers of the Bankruptcy Court should be invoked in this instance. For the court to hold that Congress could have "intended" that one class of general unsecured creditors is entitled to have its expenses paid while another class, whose interests conflict with the interests of the other general unsecured creditors, and who would not otherwise be represented, is not entitled to have its expenses paid, simply does not make sense, particularly in view of the obvious Congressional concern expressed in the Trust Indenture Act of 1939, to protect public holders of debentures (see discussion *infra* Point III and in *amici curiae brief*). Under these circumstances the indenture trustee and its counsel were in essence as "official" as was the committee elected under § 338 of the Bankrupcty Act. It is obvious that Congress simply did not foresee in 1938 that in 1972 a large company with public security holders would select Chapter XI rather than Chapter X to compose its debts, since Congress "intended" all large companies with public security holders to compose their debts under Chapter X. But it is equally significant that Congress failed to prohibit allowances to Indenture Trustees under Chapter XI. The simple fact is that Congress never considered the matter at all, and until the *Straus* case in 1966 neither did the courts.

Certainly there is nothing in such legislative history to suggest that the determination as to whether payment

may be made for services rendered by an indenture trustee should be left to the debtor. Yet under the decisions below, if the debtor selects Chapter XI the indenture trustee must work for nothing (or the debentureholders are unrepresented). If the debtor should choose Chapter X then the indenture trustee can be compensated for representing the interests of the debentureholders. This is an absurd result, since there is far greater need for independent representation of public debentureholders in a Chapter XI proceeding than in Chapter X where the SEC is present to protect the public interest and the rights of publicly held debentureholders. We see nothing in the legislative history of Chapter X or Chapter XI which even suggests that the result reached below was ever "intended", much less mandated by Congress.

POINT III

Congress Has Shown an "Intent" to Protect the Interests of Public Debentureholders in Bankruptcy Proceedings and Cannot be Deemed to Have "Intended" that they be Without Representation in a Chapter XI Proceeding

On the appeal in the District Court an *amici curiae* brief was filed on behalf of eight prominent banks supporting the Appellant's application for allowances. This brief pointed out that Congress has long recognized the important and beneficial role which indenture trustees play in Bankruptcy Act proceedings; that the services rendered by indenture trustees were of such importance to Congress that it enacted special legislation, The Trust Indenture Act of 1939, which set forth minimum requirements and standards to be included in qualified trust indentures. Thus Congress has, in effect, acknowledged that without an indenture trustee, with obligations defined both by law and in the indenture, the holders of bonds and debentures will be denied any practical opportunity to protect their interests in Bankruptcy Act proceedings.

Without attempting to repeat at length the points made in the *amici curiae* brief, we believe that it is important to emphasize that:

(a) Congress has expressly directed the courts to compensate indenture trustees for services rendered in reorganization proceedings. In a Chapter X reorganization, the judge may "allow reasonable compensation for services rendered and reimbursement for proper costs and expenses incurred . . . by the indenture trustee. . . ." Bankruptcy Act § 242, 11 U.S.C. § 642 (1938).

And § 77 of the Bankruptcy Act, providing for the reorganization of railroads, permits the judge to "make an allowance to be paid out of the debtor's estate for the actual and reasonable expenses incurred in connection with the proceeding and reasonable compensation for services in connection therewith by trustees under indentures. . . ." Bankruptcy Act § 77(c)(12), 11 U.S.C. § 205 (1935).

Clearly Congress realized, when it enacted Chapter X and Section 77, that publicly held debt securities would be involved and would have to be protected. Thus it made certain that indenture trustees in those proceedings would be able to act effectively and be compensated for their services.

(b) In contrast to Chapter X and Section 77 reorganizations, an arrangement proceeding under Chapter XI was not created initially to deal with companies having complicated financial structures. Therefore, the absence of express language authorizing the payment of allowances to indenture trustees in Chapter XI proceedings does not require the conclusion reached below that Congress was prohibiting the courts from making such awards. On the contrary, the prior actions of Congress relating to indenture trustees suggest precisely the opposite conclusion—that where indenture

> trustees would be called upon to act, Congress has insured that they will be awarded reasonable compensation for services rendered, and reimbursement for the reasonable expenses incurred, on behalf of the public security holders. As we have seen, requiring the debtor to compensate the indenture trustee becomes especially important in Chapter XI proceedings where the SEC is not present to protect the interests of the public holders of debentures and where, as in this case, the Debentureholders have interests in direct conflict with other general creditors and therefore cannot fairly and adequately be represented by the official committee.

In the instant case, compensation to the indenture trustee would seem to be almost axiomatic since the Official Creditors' Committee treated the Debentureholders as a separate class, refused to solicit consents from the Debentureholders to the Plan (requiring that such consent solicitations be made by Appellant) and refused to allow any representation of the Debentureholders on the Official Creditors' Committee. Specifically, the Official Creditors' Committee took the position that the subordinated public Debentureholders were not entitled to participate at all in the reorganization, and, but for the efforts of the indenture trustee and its counsel, the Debentureholders would not only have been totally disenfranchised but would have received absolutely nothing from the Official Creditors' Committee out of the Reorganization Plan. In these circumstances, where the Official Creditors' Committee is unable, unwilling and in effect refuses to protect the interests of the separate class of publicly held debentures, this Court, sitting with its equity power, should require compensation to the Indenture Trustee and its counsel by the debtor in accordance with the specific terms of the Indenture.

Certainly, Congress never intended, when it promulgated Chapter XI, that a class of publicly held securities which could not be and were not represented by the Official

Creditors' Committee, could only secure representation by an indenture trustee willing to expend its own funds to protect that public interest. Congress did not, of course, specifically prohibit compensation to such an indenture trustee, and it is apparent Congress was concerned that security holders of equal rank, who could be properly protected by the Official Creditors' Committee, should not be separately represented because such separate representation, if compensated by the debtor, would constitute an additional financial drain on such debtor. At most that is all that can reasonably be inferred that Congress intended when it did not specifically provide for compensating indenture trustees under Chapter XI.

Accordingly to deny compensation in this instance based on an assumed Congressional "intent" that indenture trustees should not be compensated in Chapter XI proceedings is clearly not justified.

Conclusion

The services performed by Appellant and its counsel in the present proceeding admittedly served a necessary and separate function apart from, and in addition to, the function performed by the so called "Official" Creditors' Committee and its counsel. Such services were performed on behalf of those general unsecured creditors who could not be represented by the "official" committee because of the patent conflict of interest which existed between them and the general unsecured creditor body. Nor was the Appellant indenture trustee in the nature of a "rump committee" which former Section 337(2) was designed to prevent (See, Collier, *Bankruptcy Act, supra* at A264). The Appellant Indenture Trustee represented a distinct body of creditors, i.e., the Debentureholders whose rights were being affected and adjudicated by the Chapter XI proceeding.

We submit that the granting of allowances to this Indenture Trustee and its counsel under these circumstances does

not violate the spirit of the statute with respect to compensating the representatives of general unsecured creditors as provided in Section 339. The granting of such allowance fills the technical gap in the express language of the statute and gives effect to its principle of equal treatment for all general unsecured creditors.

We submit that such a determination by this Court is in complete harmony with the intent of Congress, which in 1952, 1958 and 1967 expressly enlarged not only the function of creditors' committees, but the nature of the expenses for which they might properly be reimbursed.

Since the granting and determination of all such allowances must of necessity remain within the sound discretion of the Bankruptcy Judges, no danger can result from such a determination.

It is therefore respectfully urged that the decision below be reversed and that this Court grant the allowances sought by Appellant and its counsel, or that this Court remand this case to the Bankruptcy Court for a determination of the amounts of such allowances.

Dated: New York, New York
December 30, 1974

Respectfully submitted,

WHITMAN & RANSOM
Attorneys for Successor Indenture Trustee-Appellant
United States Trust Company of New York
522 Fifth Avenue
New York, New York 10036

JAMES C. SARGENT
ROBERT S. NEWMAN
WILLIAM M. KAHN
DUGALD C. BROWN
Of Counsel